

Annual Meeting and First Interim Report

Three Months Ended September 30, 1975

The Quaker Oats Company



AR 35

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Life Learning Program See Back Panel

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Cereal

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NET WT. 8 OZ.

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QUICK
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PUNCH



INSTANT
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The
Magic
Pan

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The Quaker Oats Company Interim Report

Six Months and Second Quarter
Ended December 31, 1975



The Quaker Oats Company
Merchandise Mart Plaza
Chicago, Illinois 60654

To our shareholders:

Net income for our first fiscal half ended December 31, 1975, was \$27.0 million or \$1.18 a share, *after* a write-off provision of \$11.9 million or 57 cents a share. The \$1.18 per share compares with 67 cents per share for the same period last year. Earnings in the first half this year *prior* to the 57 cents provision were \$38.9 million or \$1.75 per share, based on strong performance in almost all company operations.

The write-off provision results from our intention to sell all U.S., Canadian and Hong Kong operations of the Marx Toys Division as a going business. Discussions for that purpose are currently taking place. The provision reflects the write-down to estimated realizable value, less selling costs, of the net assets of the Marx operations to be sold as a going concern.

Second quarter net income, *after* deducting the entire \$11.9 million, or 57 cents a share charge related to Marx, was \$4.9 million, or 18 cents a share, compared with \$5.4 million or 26 cents a share last year. *Prior* to the 57 cents charge, per share income for this year's quarter was 75 cents.

Marx was acquired on June 30, 1972, and was profitable in the fiscal year ended June 30, 1973. Earnings declined significantly in fiscal 1974, and in fiscal 1975 the Marx operations to be sold had an operating loss of \$13.2 million, including a substantial charge for the elimination of certain toy lines and the consolidation of facilities. Operating losses have continued to be very substantial in the current fiscal year. (Operating loss is defined as loss before deduction of interest and income taxes.)

Our intensive study of Marx concluded that divestiture is clearly the best alternative in the context of our total business strategy. For this reason, discussions were begun with potential purchasers. Meanwhile, Marx operations are continuing. Our 56% interest in the profitable

Marx operations in Mexico is not part of the discussions.

Grocery products operations worldwide continued the strong performance reported in the first fiscal quarter. In the United States, dollar sales and operating income of cereals, mixes and frozen foods in the first half were up substantially. Sales of pet foods in the U.S. were about the same as last year, but operating income was much improved. Sales and income were also up in our Canadian and international grocery businesses.

Grocery margin improvement was significant in the second half (January-June, 1975) of the prior fiscal year, which will affect our year-to-year comparisons in the second half of the current 1976 fiscal year.

Sales and profitability of our Fisher-Price Toys, Burry, Needlecraft and Magic Pan Divisions for the six months improved significantly over last year.

Chemicals Division sales were up, although there is increasing softness in the foundry industry. Operating earnings were below last year's record level as a result of unfavorable foreign exchange rates and costs associated with the large, new Texas plant, which will not begin generating any sales until the planned start-up at the beginning of the next fiscal year. Product allocations have been removed based on increased capacity at the Belle Glade, Florida plant and the expectations of initial supplies from the Texas facility.

We are pleased by the excellent overall performance of the business in the first half. Necessary business decisions such as the one we have made on Marx are very difficult, but imperative to the company interest, strength and growth over the long term.

Robert D. Stuart, Jr.

Robert D. Stuart, Jr.
President and
Chief Executive Officer

February 5, 1976

The Quaker Oats Company and Subsidiaries
Condensed Statement of Consolidated Income (Unaudited)

	Thousands of Dollars	
	Three Months Ended December 31	Six Months Ended December 31
	1975	1974
Revenues:		
Net Sales	\$ 394,840	\$ 372,734
Other income (expense)—net	(26,644)	(3,502)
	<u>368,196</u>	<u>369,232</u>
Costs and Expenses:		
Cost of goods sold	271,602	282,484
Selling, general and administrative expenses	81,552	67,323
Interest expense	4,579	8,593
	<u>357,733</u>	<u>358,400</u>
Income before income taxes	10,463	10,832
Provision for income taxes	5,525	5,399
Net income	4,938	5,433
Preferred dividend	107	106
Preference dividend	1,195	—
Earnings available for common	\$ 3,636	\$ 5,327
Net income per common share	\$.18⁽¹⁾	\$.26
Average common shares outstanding	20,700,738	20,699,008

Interim results are not necessarily indicative of performance for the full year, and are subject to adjustment during the remainder of the fiscal year.

- (1) After the write-down to estimated realizable value, less selling costs of Marx operations in the U.S., Canada and Hong Kong to be sold as a going concern, equivalent to 57 cents a share.

Condensed Consolidated Balance Sheet (Unaudited)

Assets

December 31	Thousands of Dollars	
	1975	1974
Current Assets:		
Cash and marketable securities	\$ 58,774	\$ 24,221
Receivables—net	136,713	145,489
Inventories	190,294	214,789
Other current assets	<u>9,294</u>	<u>27,594</u>
Current assets	395,075	412,093
 Other Receivables and Investments	 6,686	 6,028
 Property, Plant and Equipment—net	 366,053	 336,578
 Intangible Assets	 <u>44,682</u>	 <u>44,418</u>
	<u>\$812,496</u>	<u>\$799,117</u>

The Quaker Oats Company and Subsidiaries

Liabilities

December 31	Thousands of Dollars	
	1975	1974
Current Liabilities:		
Short-term debt	\$ 53,268	\$111,235
Dividends payable	5,650	4,246
Other current liabilities	140,975	121,972
Current liabilities	199,893	237,453
Long-Term Debt	137,493	170,065
Other Liabilities	12,525	8,689
Deferred Income Taxes	46,068	38,971
Shareholders' Equity:		
Preferred, \$50 par value, \$3 cumulative convertible, authorized 147,811 shares; issued 142,079 shares	7,104	7,105
Preference, without par value, \$100 stated value, \$9.56 cumulative, authorized 1,500,000 shares; issued 500,000 shares	50,000	—
Common, \$5 par value authorized 35,000,000 shares; issued 20,955,758 and 20,948,922 shares, respectively	104,779	104,745
Additional paid-in capital	22,883	23,882
Reinvested earnings	237,378	213,834
	422,144	349,566
Less treasury common stock, at cost	5,627	5,627
Shareholders' equity	416,517	343,939
	<u>\$812,496</u>	<u>\$799,117</u>

The Quaker Oats Company and Subsidiaries
Condensed Consolidated Statement of Changes in
Financial Position (Unaudited)

Six Months Ended	Thousands of Dollars	
	December 31 1975	December 31 1974
Sources of Working Capital:		
Operations:		
Net Income	\$ 26,966	\$ 13,991
Depreciation, amortization, and deferred income taxes	20,356	18,359
Total from operations	47,322	32,350
Provision for proposed sale of certain operations	8,600	—
Other—net	1,964	655
Total provided	57,886	33,005
Uses of Working Capital:		
Additions to properties	32,051	33,196
Cash dividends declared	11,298	8,493
Decreases in long-term debt	20,790	1,362
Excess of cost over working capital of acquired businesses	5,557	208
Other—net	1,721	(431)
Total used	71,417	42,828
Decrease in Working Capital:	\$ 13,531	\$ 9,823
Consisting of:		
Cash and marketable securities	\$ 41,168	\$ 12,539
Receivables—net	(7,638)	(14,640)
Inventories	1,590	(10,382)
Other current assets	2,283	18,299
Short-term debt	(24,740)	3,459
Other current liabilities	(26,194)	(19,098)
Net Decrease	\$ (13,531)	\$ (9,823)

An Important Announcement for Owners of Quaker Common Stock.

It was announced at this year's Annual Meeting that, effective with the January 20, 1976, dividend payment, the Company will pay all service charges and brokerage fees for shareholders who wish to participate in the voluntary Automatic Dividend Reinvestment Service for owners of common stock. This change in the program will allow participating shareholders to automatically use dividends, plus any cash deposits they care to

Quaker Directors are listed on page 19 of this report.

Proposals

The Directors' appointment of Arthur Andersen and Co., Chicago, as independent auditors for the 1976 fiscal year was approved by more than 99% of shares voted.

A proposal by Mr. Lewis D. Gilbert, a shareholder, to require a minimum of ten meetings a year of the Board of Directors was defeated by more than 98% of shares voted. It was noted that, during the 1975 fiscal year, the Board held six regularly scheduled meetings in accordance with the By-Laws and three special meetings, as dictated by the needs and opportunities of the business.

A proposal by Mrs. Evelyn Y. Davis, a shareholder, to require the Company to publish advertisements in various newspapers listing contributions of Company funds to political parties or campaigns, referenda and related activities, was defeated by more than 97% of shares voted. Company policy does not permit such contributions and, to the best of Management's knowledge, none were made.

The meeting was adjourned at 11:25 a.m.

First Interim Report

The report to shareholders for the first fiscal quarter ending September 30, 1975, begins on page 20.

make, up to \$1,000 per month, to purchase additional shares of Quaker common stock. This important change is discussed in greater detail in the Annual Meeting Report. (See page 15 of this booklet.) If you would like complete information, please mail the Business Reply card inside the back cover.

In order for your January dividend to be reinvested, it's necessary that we receive your authorization card by the December 24, 1975, record date. If your card is received after that date, participation will begin with the April dividend. The service is entirely voluntary and you may join or withdraw at any time.



The Quaker Oats Company
Merchandise Mart Plaza
Chicago, Illinois 60654

Annual Meeting Highlights

The Annual Meeting of Shareholders of The Quaker Oats Company was convened at 9:30 a.m. on Wednesday, November 12, 1975, at The Northern Trust Company in Chicago. Robert D. Stuart, Jr., President and Chief Executive Officer, presided. Approximately four-hundred shareholders were present.

Board of Directors

Fifteen incumbent Directors were reelected to the Board and two nominees were elected to new seats, for a total of 17. The new Directors are Dr. Thomas C. MacAvoy, President and a Director of Corning Glass Works in Corning, New York, and Mr. Fred D. Stone, who joined Quaker in January, 1975, as Senior Vice President — Finance. The names and principal affiliations of all Quaker Directors are listed on page 19 of this report.

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Report to Shareholders

At the Annual Meeting this year, shareholders heard reports from Robert D. Stuart, Jr., President and Chief Executive Officer; Kenneth Mason, Executive Vice President — Grocery Products Area; and W. Fenton Guinee, Executive Vice President — Diversified Businesses Area. These reports, which are reprinted below, were followed by a question-and-answer period, which is summarized beginning on page 17.

Mr. Stuart: This is the largest attendance we've ever had for our Annual Meeting, and we're very pleased that all of you are with us today.

In reporting lower results for the fiscal year ending last June 30, we stressed both the reasons for those results and the reasons we expected them to improve. In the Annual Report I wrote you,

As we look ahead after a difficult year we are confident that the tough corrective measures, the improved organization and the more effective internal controls initiated in fiscal 1975 have markedly strengthened the Company.

With the first quarter now behind us, following the good trends that developed in the second half of last fiscal year, we have reason to feel confident that we're back on the track again after a couple of difficult years.

First Quarter Results. For the first quarter of the current fiscal year, our results were much improved, not only because of the improved economic climate but also due to more effective management of our business. Sales increased from \$344 million to \$385.7 million. Net income was \$1.00 a share, almost two-and-a-half times the 41 cents a share of last year, when earnings were depressed by unsatisfactory grocery margins and slow trade ordering in toys. We won't continue that rate of improvement for the full twelve months, but we're off to an excellent start, and we should have a record year.

In fiscal 1973, our best year so far, we earned \$2.04 a share. Coincidentally, for the most recent twelve-month period — the last nine months of last fiscal year and the first quarter of fiscal 1976 — our earnings were also \$2.04 per share. Both the first and second quarters a year ago were very weak; so you can see that if this year's second quarter holds up in toys and the remainder of the year stays reasonably on course as we expect it will, fiscal 1976 will be a record year. We still have some problem areas, however, and I don't want to speculate on just how substantial that record will be.

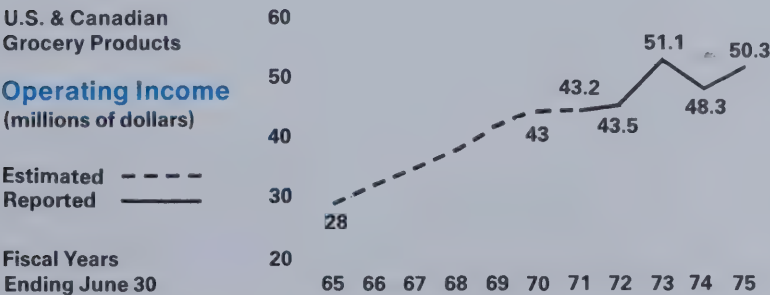
As indicated in our first-quarter earnings announcement, profits in the Grocery Products Area were primarily responsible for the significantly improved quarterly performance.

Two Business Areas. Last January all our operating groups and divisions were divided into two major business areas. The Grocery Products Area consists of consumer foods and pet foods businesses worldwide. It accounted for about two-thirds of our sales and profits last year. The Diversified Businesses Area – consisting of six divisions with products sold primarily through non-grocery channels – accounted for roughly the other third of sales and profits.

Each of these Areas is now headed by an Executive Vice President, who has chief operating officer responsibility for his respective businesses. In a few minutes we'll hear from Fenton Guinee, Executive Vice President – Diversified Businesses Area. First, however, I'm pleased to introduce Ken Mason, Executive Vice President – Grocery Products Area.

Mr. Mason: It's always a pleasure for me to have the opportunity to talk about our remarkable grocery business, but it's especially pleasant to do so when year-to-date earnings are running at an all-time high. My initial remarks pertain to the U.S. and Canadian grocery operations, which last year accounted for more than 75% of our Area sales and more than 80% of Area operating income.

U.S. and Canadian Grocery Earnings. Most of you will recall that our U.S. and Canadian Grocery Products Group was showing good earnings growth from the middle of the 1960's through 1973. In fiscal 1974 earnings for the Group declined approximately 6%, however, and in 1975 remained still depressed below the 1973 level.



Note: Fiscal 1971 was the first year Operating Income was reported separately for the U.S. and Canadian Grocery Products Group. Earlier-year data are estimated.

These last two years have been a disappointment to all of us, and even led some people to question whether our basic grocery business was going into a permanent decline. In answer to this question we have been very consistent on two points:

The first is that a business as mature and as diverse as ours simply cannot be properly analyzed on a short-term basis. The second point is that the fiscal 1974 and 1975 results reflect some very unusual and, we believe, temporary conditions in the economy, but not an inherent long-term profitability problem.

These special and temporary conditions were price controls, which in fiscal 1974 practically wiped out our first-quarter operating margins completely; and the very erratic behavior of the grain and commodity markets in both fiscal years, but particularly in 1975. As an example, in the fiscal year just ended, the price we paid for sugar increased by more than \$25 million just for this one commodity alone.

A third problem adversely affecting our 1975 results was the consumer shift from canned pet foods, where we have had a very strong market position, to lower-priced dry pet foods, where our position is unfortunately quite weak. This shift, we believe, is closely related to the economic downturn. Thus, it's our hope that, as economic conditions improve, sales of our canned pet foods may very well improve also.

The main point I want to leave with you is that even with the problems we have talked about, our U.S. and Canadian grocery business finished last year just a fraction below the record year of 1973 — without any cutback at all in our marketing efforts or in our expenditures for research and development, where a cutback might prejudice future growth.

Outlook for the Current Year. So much for why fiscal 1974 and 1975 were disappointing. Now, the happier question of why 1976 is looking so good.

One reason is that commodity prices have declined. Our costs for key ingredients rose very dramatically from 1971 to 1975, and now appear to be leveling off and, in some cases, actually declining. Of course, no one expects these costs ever to go back to the levels of the early 1970's, but the return of stability to the commodity markets, assuming that's what we are seeing, is having and will continue to have a very favorable effect on our future profitability.

Principal U.S. Markets

Spot Commodity Prices

Commodity	September 30		
	1971	1974	1975
Oats (Bu)	\$.66	\$ 1.98	\$1.68
Corn (Bu)	1.12	3.87	2.94
Wheat (Bu)	1.55	4.52	4.25
Soybeans (Bu)	3.07	8.58	5.54
Sugar (Cwt)	12.70	40.85	21.45

Source: USDA Grain Market News

A second reason for the dramatic improvement our grocery business is experiencing in the first quarter of this year is that, with the exception of pet foods, our sales are generally showing good trends. Our cereals business in the United States, for instance, is up 5% in tonnage. Dollar sales would show a much larger percentage increase. This chart shows the change in pound volume for major sectors of the Grocery Products Area.

Grocery Products Area

Worldwide Sales Trends

First Quarter, Fiscal 1976 vs. Fiscal 1975	Percentage Change in Pound Volume
United States:	
Cereals*	+ 5
Mixes, Syrup and Corn Products	+ 8
Pet Foods	- 4
Frozen Foods	+16
Canada	+17
Europe	+ 1
Latin America and Pacific	+12

*Excludes Industrial Sales

Good trends are particularly noticeable in hot cereals and pancake mixes, products that offer exceptional value to the consumer in difficult times, and also — because of the many years we've been leaders in these markets — that generally provide us with higher margins than some of our other products. Though pet food tonnage is down 4% from last year, an outstanding cost reduction program has enabled the Pet Foods Division to greatly increase its productivity in this first quarter and show much higher earnings despite a volume decline.

A third factor in our good performance in the first quarter this year is the simple fact that we are getting more realistic prices for our products.

Like many other food manufacturers, inflation has forced us to raise prices of our products more frequently than either we or the consumer would like. We've tried to walk the middle of the road, holding prices down as much as possible while still recognizing the necessity of restoring our margins to a level high enough to assure a reasonable return on investment.

If we take our first quarter of fiscal 1976 and compare it directly with the first quarter a year earlier, our wholesale prices for all grocery products now are up about 12% worldwide from last year's first quarter — less than 12% in the United States alone.

It's our expectation that prices will generally remain at current levels, and there is a possibility of some selective price decreases between now and the end of the fiscal year. This, of course, depends on a number of factors such as the economy and the weather, over which we have no control.

To sum up, for the first quarter, generally higher sales, more favorable commodity costs and more realistic pricing than we had a year ago, plus a program of intensified cost control — particularly in pet foods — have produced an operating income for grocery products worldwide of \$31.5 million, which is an increase of more than 200% from the first quarter of last year.

Grocery Products Area
Operating Income

First Quarter, Fiscal 1976 vs. Fiscal 1975 **(Dollars in Millions)**

	Three Months Ending Sept. 30		Twelve Months Ending Sept. 30	
	Amount	Improvement	Amount	Improvement
U.S. & Canada	\$27.1	247%	\$69.6	27%
International	\$ 4.4	159%	\$14.2	4%
Area Total	<u>\$31.5</u>	232%	<u>\$83.8</u>	23%

Obviously, it's not relevant or realistic to simply compare one quarter with another. It's too short a term. Looking at the right-hand column of the chart above, for the full 12 months ending September 30, 1975, our increase over last year is a much more understandable 23%. While it's still too soon to predict that we are going to be able to — or even want to — maintain the current

rate of increase throughout the fiscal year, it does appear at this time that fiscal 1976 results for our worldwide grocery business are going to be better than any previous year in our history.

New Products. I'd like to call your attention as American consumers to some of the products that are new this year in the United States or have expanded their distribution into new areas since our last annual meeting:

From the Foods Division: Aunt Jemima Whole Wheat Pancake Mix, 100% Natural Cereal with Apples and Cinnamon, Instant Quaker Oatmeal with Cinnamon and Spice and Cap'n Crunch's new Punch Crunch. Among our frozen foods: Celeste Pizza in a smaller size for more attractive pricing and Aunt Jemima Frozen Pancake Batter in three varieties.

From the Pet Foods Division: Ken-L Ration Burger 'n Egg, Burger and Liver-Flavor Chunks and a new chicken-flavor variety of our canned Ken-L Ration dog food.

Our research tells us, as does our intuitive feeling for the market, that consumers have re-learned some very basic lessons about value during the recent recession. They have become very careful, knowledgeable and selective about what they buy. Now, this doesn't mean, in our opinion, that consumers are looking just for the cheapest products. Instead, they are seeking the best value relative to their own particular circumstances. Viewed this way, higher-priced convenience foods will do well so long as consumers believe the value added to those products is really worth the price. But at the same time, fine, low-cost foods such as our oatmeal and cornmeal — where we enjoy such strong and unique positions — have earned a new and permanent badge of desirability in the marketplace.

Thus, our strategy of maintaining the value of our great basic products, while concentrating new product effort on items that offer both the retailer and the consumer distinctive value, seems very sound to us in this particular economy. Our Quaker 100% Natural Cereal, which has built a whole new market, is one example of what we are talking about. It is also true that we haven't developed as many distinctive products as we should have in the last few years, but I assure you we expect to do better in the years to come.

Now, let me introduce Fenton Guinee, Executive Vice President — Diversified Businesses, to discuss results and trends in the non-grocery portion of our business.

Mr. Guinee: The Diversified Businesses Area is made up of six divisions: Fisher-Price Toys, Marx Toys, Needlecraft, Chemicals, Burry and Magic Pan Restaurants. Each of these has diverse operating characteristics, opportunities and problems. Five of the six divisions were acquired; the Chemicals Division was developed internally.

From fiscal 1971 through 1975, dollar sales volume in the Diversified Businesses Area grew from \$165 million to \$429 million. In the same five-year period, these divisions grew from 23% to 31% of Quaker's consolidated sales.

Operating income for the Area increased from \$18 million in fiscal 1971 to \$39 million in fiscal 1973, or from 27% to 40% of the Company's total. The increase in these two years was due primarily to the toy divisions, particularly Fisher-Price, and was a principal factor in Quaker's total earnings increase in fiscal 1972 and 1973.

In fiscal 1974 and 1975, earnings in Diversified Businesses declined to \$35 million and \$32 million, respectively – due to substantial reductions in the earnings of the toy divisions, which were only partially offset by results of the other four divisions.

Fisher-Price Toys. Let's look at Fisher-Price from calendar 1970 through calendar 1974. (In discussing the toy divisions, I will use *calendar* years because that is the time frame in which the toy industry generally views its business.) In the last five years, Fisher-Price's volume has grown from \$54 million to \$148 million.

The bulk of this increase came from higher sales of pre-school toys. More recently, Fisher-Price has expanded into several new categories: infant toys, dolls, and construction vehicles. This year a series of adventure toys is reaching an older age group, which represents a significant expansion strategy for Fisher-Price. The division has also expanded its international operations considerably.

For the first nine months of calendar 1974, dollar volume of toy industry shipments ran about 14% ahead of the prior year. But in the last quarter, retailers were concerned about the probability of a recession. They did not place their normal volume of Christmas orders, and shipments for that period dropped about 10%. This rather drastic shift was experienced fairly broadly across the industry. It caught Fisher-Price and many others with excess

inventory. To correct this situation, production was sharply reduced in the early months of calendar 1975.

For the first half of the current calendar year, industry shipments lagged behind prior-year figures by 11%. However, there was an upturn in July and August, when shipments were 4% above the prior year.

Our information indicates that retailers' inventories are now significantly below last year's levels. Therefore, given normal consumer purchasing for Christmas this year, retailers will have to buy heavily to satisfy consumer demand.

For the nine months through September, Fisher-Price achieved its profit goals. The July-September quarter was good for the division, and the profit outlook for all of 1975 is favorable. This, in combination with some significant reductions in working capital, should result in a substantial improvement in the return on investment.

Marx Toys. Marx was acquired in June, 1972, and operations during that year were quite satisfactory, but they have not been so since. Results this year have not been good. New competitors have entered several of Marx's important product categories. Extensive changes in a number of areas have been costly and, frankly, more difficult than anticipated. As you know, a charge was made against earnings last year to cover the cost of eliminating certain product lines and of consolidating facilities.

Corporate and divisional management have been working for some time to determine the best course of action for Marx. We are continuing to intensively study the situation, and expect to have the results of our studies in the near future.

Needlecraft. The Needlecraft Division was acquired at the end of fiscal 1972. DuPont, the major producer of craft yarn fibers, has estimated that there was an explosive sales growth from 1969, when fiber sales were 42 million pounds, to 1972, when sales had more than doubled to some 98 million pounds. The industry continues to grow, but now at a much more modest rate.

In its first two years with Quaker, Needlecraft results were affected by the market conversion from wool to synthetic yarns, some plant start-up problems and margin pressures. I'm happy to report that Needlecraft resolved many of these problems in fiscal 1975, and increased both earnings and the rate of return. This trend has continued through the first quarter of this year.

Chemicals Division. Quaker entered the chemicals business in the 1920's as a result of new technology we developed for the commercial production of a useful chemical called furfural from oat hulls — a by-product of our grain milling operations. In recent years, the Chemicals Division has become an increasingly important part of our overall corporate portfolio. Its dollar volume since fiscal 1971, when sales were \$38.7 million, has grown approximately 25% a year. Last year sales were \$97.2 million, accompanied by a substantial increase in earnings. The division had a good first quarter this year.

Metal foundries constitute the largest market for Quaker chemicals, which are used to bond sand in cores and molds in the casting process. Furfuryl alcohol, which is made from furfural, is used in this process. Furfuryl alcohol does not compete in every foundry application, but the market in which it does compete is estimated to be approximately a half billion dollars in size. Synthetic binders, of which furfuryl alcohol is only one, have grown from 10% of that market in 1965 to 30% in 1975, and the trend continues upward.

Our sales to date have been relatively immune to economic fluctuations in the foundry business. The combination of foundry operators' increasing awareness of the advantages of Quaker chemicals and the low penetration that these chemicals currently have in the market provides substantial opportunities for further growth. In addition, Quaker technology is steadily expanding the useful applications of our chemicals.

Demand has been in excess of capacity for the last two years, and we have had to allocate available supplies. Construction of the major new plant in Bayport, Texas, is on schedule and will provide additional product next fiscal year. Expansions in Belgium and Florida were completed in the last fiscal year. These very significant capital investments are important to meeting our customers' needs.

Raw materials now used to make furfural consist of such agricultural wastes as corn cobs, oat hulls, sugar cane bagasse and rice hulls. Our principal competition comes from chemicals derived from petroleum.

Though our raw material costs haven't gone up as much as petroleum, we have experienced very significant increases in both the cost of these raw materials and the expense of transporting them to our plants. Since 1971 our total raw material

costs have increased about 60%, with virtually all of the increase coming in the last two years.

The chemical business is highly capital-intensive, as you know. Despite substantial advances in processing technology, the costs of new facilities in the industry have risen very substantially since 1971, with most of the increase also taking place in the last year or two. By the end of 1976, it is estimated by some authoritative sources that chemical plant costs will have doubled from their 1971 level.

Because our Chemicals Division is growing, and because we have to make substantial additional investment in plant and equipment to keep up with demand, we are pricing our products to provide a fair return on the value of the investments we are making now.

To wrap up this brief report on chemicals, there are some important advantages in this business that are worth emphasizing:

First, we have unique technology and facilities for processing highly corrosive materials into chemicals with distinctive properties.

Second, we have extensive ability and experience in collecting, storing and feeding into our processes the massive amounts of agricultural materials that are required. Unless you have seen these supplies, it is difficult to imagine how logistically complicated this job is.

Third, we have excellent research and development and field marketing efforts, which have discovered unique product uses and then developed the commercial markets for them. In both of these areas we feel we are still only scratching the surface.

The net of all this is that our chemicals business is now a very sophisticated operation, light-years away from the early 1920's when only laboratory curiosities were produced from oat hulls.

Burry Division. Some years ago Burry was one of the Company's problem areas. More recently, a new management team, after first scaling back the operation, has consistently improved both earnings and return on investment. Progress has continued through the first quarter of the current year.

We are particularly pleased with the achievement of the Burry Division's management because their progress has been made despite the static nature of the markets in which they compete.

Magic Pan Restaurants. From 1967 to 1972, approximately 20% of the dollars spent on food in this country was for consumption outside the home. This figure has now moved up to more than 25%. The penetration is even higher among growth-population sectors such as persons 25 to 34 years of age, single people, and more affluent consumers. While predictions of the share by 1980 vary from 30% to 50%, all forecasters seem to agree that food consumption outside the home market will increase significantly.

Quaker entered this industry with the acquisition of two Magic Pan restaurants in 1969. Growth was deliberately slow at first until the operation was perfected and confidence was gained in our ability to deliver planned results. Volume growth in the last couple of years has materially improved our overhead ratios. Our gross margins have been maintained while continuing to provide appetizing food in attractive surroundings at reasonable prices.

Magic Pan had a very good first quarter this year. Thirty-one restaurants are now open, and we expect to increase the rate of openings somewhat in the future.

Mr. Stuart: Let me conclude this report by stressing five points and then making an announcement that I know will be of interest to all individual shareholders.

The five points are:

- 1) organization strength
- 2) financial strength
- 3) market strength
- 4) our objectives and plans
- 5) our corporate values

Organization Strength. Ken Mason and Fenton Guinee, the officers that you have heard from today, along with our other corporate and divisional people, represent the strongest organization, the best management team, that Quaker has had since I have been on the job. I think Ken's and Fenton's remarks reflect the quality of thought and leadership that is being applied to Quaker's growing business.

Financial Strength. Our organization is complemented and supported by a very strong financial position, much improved over a year ago. At the end of fiscal 1975, our ratio of long-term debt to total capital was 28.3%, down from 33.6% a year ago. Domestic short-term borrowing was only \$5 million, compared with \$81 million at the end of June the prior year.

At September 30, the end of this year's first quarter, total debt was \$120 million less than it was a year ago. Approximately \$50 million of this resulted from last year's sale of preference stock. But \$70 million is from lower working capital employed in the business. We have placed a great deal of emphasis on more efficient and effective use of capital, and it has produced results.

Our business has been enhanced by the modified organization structure that we established in January, 1975.

As a result of more decentralized delegations of authority, we have become leaner and more flexible. At the same time, we have improved the financial controls that are so necessary to the management of a diversified company.

Market Strength. Very few companies have as many basic market positions with such strong consumer and customer franchises as The Quaker Oats Company. Ken and Fenton mentioned many of them. I'd just like to remind you that there is a common denominator that makes their strength so secure: *quality and value*. Quaker Oats, Aunt Jemima, Fisher-Price, Ken-L Ration, Puss 'n Boots, Life Cereal, Cap'n Crunch and our specialty chemicals, just to mention the largest. But, of course, there is Magic Pan, Burry, Celeste, the Marx Big Wheel, the fine specialty business of Needlecraft and their Herrschners mail-order house. We have the leading chocolate business in Mexico and the principal sardine business in Brazil, along with several other well-known international product lines. The market strengths of these diverse brands and product lines provide both security and opportunity.

Objectives and Planning. It's been a traditional Quaker policy to maintain a conservative balance sheet and a strong financial position.

More than seven years ago, in May of 1968, we established an earnings objective, which I described to you in the 1969 Annual Report:

"Our objective is to maintain a per-share earnings improvement averaging 10% per year over any five-year period. Year-to-year improvements obviously will be dependent upon new product and business opportunities, the stability and strength of the economy and the level of corporate taxes."

We've always tried to stress the long term, deliberately not stating a one-year objective and recognizing both market-opportunity timing and economic swings. Until the 1974 and 1975 fiscal years, when price controls, the commodity cost escalation and the consumer recession knocked us off course, we exceeded the objective.

Beginning in the second half of fiscal 1975 (January-June of this year), we began again to make good progress against our own and any reasonable financial and marketing objectives. We now believe that the long-term 10% objective is probably a floor under what we must do in the future.

I don't mean to imply by this that we think we couldn't have done better than we did in the last two years; we all are conscious of things we might have done differently. I do mean to suggest, though, that it would have been abnormal for our businesses to have been unaffected by the recession. We are pleased, now that we're in a stronger economy, to see that we did nothing during the two-year period to jeopardize our long-term strength.

We continue to place high priority on maintaining a strong financial position, on improving return on invested capital, and preserving the strong market positions of our numerous major product lines. These goals are more important, we believe, than trying to get regular earnings growth in a volatile economy, either quarterly or even annually. We are now positioned for growth, both internally and via acquisitions — although we have no specific acquisition in mind at the moment.

Closely related to financial objectives is our overall planning program to determine strategic future directions. This has very high priority. In early July of this year we met on this subject with the full Board of Directors for two days. Later the Executive Committee met for two days on long-range planning. Not all our problems are behind us, and not all our opportunities are fully defined. But we have many more of the latter than we do of the former, and we are intensively examining and making decisions in both areas.

Corporate Values. The Quaker Oats Company has always had a high set of standards. We believe they are an important part of our heritage and a great corporate asset. We regret the low standards of behavior in some companies that have been so heavily publicized recently, and we deplore the rationalizations that have been used to try to justify corporate behavior that is clearly wrong.

We are pleased that Quaker's name is untarnished, and we are going to maintain it that way. We have extreme confidence that all our managers understand and embrace the Company's high standards.

Shareholder Developments. I want to talk a little about some good news for our individual shareholders: One of my personal hopes has long been that every consumer of our products could be an owner of our stock. Obviously, that will never happen. But we are interested in doing everything we can to make it easy for consumers who want to own Quaker shares to do so.

Shareholders should be loyal consumers: that benefits all of us. And we're pretty confident that an investment in our stock isn't the worst decision a consumer could make! So it's the best of both worlds.

We consider the individual small shareholder to be very important. We added about 2,700 new shareholder accounts in fiscal 1975, more than a 10% increase just in the past year. The majority of these were smaller holdings, including many employees who bought Quaker common stock for the first time.

Perhaps you have seen the recent comments from the Chairman of the New York Stock Exchange, reporting that several million shareholders have dropped out of the market since 1972. Not only did Quaker add 2,700 shareholders just last year, but since 1972, our number of shareholder accounts has grown by 21%. We had 21,900 accounts back in 1972, and we now have 26,600. It seems our concern for individual shareholders is working well for us, and we think it's good for you.

Automatic Dividend Reinvestment. In 1971, we established an Automatic Dividend Reinvestment Service. Dividends for shareholders who signed up for this program are sent directly to the bank where they are invested in additional shares of Quaker common stock at prices prevailing when the bank purchases the shares. In addition, many of you have taken advantage of the opportunity to make voluntary cash deposits with the bank, which are also used to buy additional Quaker shares. In other words, you can have your dividends automatically reinvested and also invest new money through the program.

To date, more than 2,000 Quaker shareholders are participating in the program, thereby saving time, adding to their holdings in a very convenient and regular way and, in particular, making their purchases at lower costs than is possible when buying through conventional brokerage means. This last point is important because recent changes in brokerage industry rates have had the effect of raising the cost for many small transactions.

Effective with our next dividend payment on January 20, 1976, the Company will assume *all costs* of participation in Automatic Dividend Reinvestment. No longer will you pay even a small service charge or portion of commission. Every dollar put into the plan in your name, whether from Quaker dividends or from your own additional cash investment, will be used to purchase Quaker shares. The plan will not only be convenient and time-saving, but it will be available to you at no cost. Those of you already participating need take no action at all; from the January dividend onward, your additional shares will be purchased with no commission or service charge. But if you wish to sign up for Automatic Dividend Reinvestment for the first time, the office of the Corporate Secretary will be happy to supply you with the appropriate authorization form.

Our report this year has been longer than usual, but we really think it's important for you to understand our business as completely as possible. So, let me conclude simply by saying that it's most pleasant to tell you we believe we are back on the track and our long-term outlook is very good.

Discussion Summary

Do the auditors receive all the information they need to conduct their audit in the optimum manner?

A representative of Arthur Andersen and Company told shareholders the staff of his firm has received all information requested of Quaker, its vendors, customers and bankers in the course of conducting its audit.

W. T. Grant and Company has filed for reorganization under the bankruptcy laws. Since Grant's sells Quaker products, what are the probable consequences to Quaker?

Grant's has been a large customer of Quaker's two toy divisions. The Accounts Receivable reserve in existence at September 30, 1975, appears to be adequate to cover any losses that may result from the Grant's situation. Merchandise is currently being shipped to Grant's on a cash-in-advance basis.

Were all types of financing considered before it was decided to sell \$50 million in \$9.56 Preference shares?

Yes, all relevant financing approaches were considered by the Board and Management. Preference shares were selected to provide additional equity, thus strengthening the Company's balance sheet in a manner consistent with the long-term interests of shareholders. If bonds had been chosen instead, they would have added to the Company's debt.

What is the book value of the common stock?

At June 30, 1975, book value per common share was \$16.60, compared with \$16.01 at the end of the prior fiscal year.

Do the investment portfolios of Quaker's pension funds contain any bonds of the City of New York?

No.

Did the National Advertising Review Board challenge Quaker about advertised claims for Ken-L Ration dog food?

Yes. Even though we were fully prepared to support our advertising claim, the question was moot, since the television spot commercial was no longer being used.

Quaker was one of the prime movers in the establishment of the National Advertising Review Board, and we continue to believe that this sort of industry self-regulation is clearly in the public interest.

Other discussion. In addition, there was discussion of advertising expenditures, foreign currency reserves, fees paid to outside Directors, and other matters already discussed in Quaker's 1975 Annual Report, the Proxy Statement and other public statements.

Members of the Board of Directors

Mr. Silas S. Cathcart

Chairman and Chief Executive Officer
Illinois Tool Works, Inc.
(Diversified Products)
Chicago, Illinois

John D'Arcy, Jr.

Senior Vice President
Operations and Administration

W. Fenton Guinee

Executive Vice President
Diversified Businesses

Richard D. Harrison

President and Chief Executive Officer
Fleming Companies, Inc.
(Wholesale and Retail Foods)
Oklahoma City, Oklahoma

Augustin S. Hart, Jr.

Senior Vice President
Planning

Thomas C. MacAvoy

President
Corning Glass Works
(Specialized Glass and Ceramic
Products)
Corning, New York

Kenneth Mason

Executive Vice President
Grocery Products

Archibald McClure

Group Vice President
Industrial and Institutional Products

Donald E. Meads

Chairman and Chief Executive Officer
Certain-teed Products Corporation
(Building Materials)
Valley Forge, Pennsylvania

G. G. Michelson

Senior Vice President
Macy's New York
(Retail Merchandising)
New York City

Dr. Walter J. Salmon

Associate Dean for Educational Affairs
and Professor of Marketing
Harvard Business School
Boston, Massachusetts

Frank C. Schell, Jr.

Group Vice President
Toys and Recreational Products

Gilbert H. Scribner, Jr.

President, Scribner & Co.
(Real Estate Brokerage,
Management & Appraisals)
Chicago, Illinois

Fred D. Stone

Senior Vice President
Finance

Robert D. Stuart, Jr.

President and Chief Executive Officer

Robert N. Thurston

Senior Vice President
Corporate Affairs

Arthur M. Wood

Chairman and Chief Executive Officer
Sears, Roebuck and Co.
(Retail Merchandising,
Insurance and other services)
Chicago, Illinois

First Interim Report

Three Months Ending September 30, 1975

On October 29, the Company reported new records in both sales and earnings for the first quarter of the 1976 fiscal year. Net sales were \$385.7 million, compared with \$344 million in last year's first quarter.

Net income was \$22.0 million or \$1.00 per share, compared with \$8.6 million or 41 cents a year ago. In the July-September quarter last year, grocery margins were depressed as a result of the escalation in key commodity prices, and there was also slow trade ordering in toys. This first quarter's exceptional rate of improvement will not be sustained for the full year, although good, broadly based operating results for the 1976 fiscal year are expected, with increases from most divisions of the company.

Results of U.S. and international grocery products operations were the principal factor in the improved performance. Profit margins, which were very unsatisfactory in the first quarter last year and the year before, have now recovered substantially, continuing the improvement that began in the second half (January-June) of the 1975 fiscal year.

The significant profit gains in U.S. and international grocery products were accompanied by dollar sales increases in all divisions except domestic pet foods, where there was a slight sales decline but improved profitability.

Sales in the Toys and Recreational Products Group were about the same as in last year's first quarter. Group operating profit was up, with improved results at the Fisher-Price and Needlecraft divisions and unsatisfactory performance at Marx. Toy division results for the calendar year will depend heavily on pre-Christmas sales in the present quarter.

The Industrial and Institutional Products Group also increased sales and earnings over the first quarter of last year.

Net interest expense was \$4.5 million, compared with \$8.3 million last year, reflecting both a reduced level of borrowing and lower interest rates.

The consolidated financial statements on the following pages include The Quaker Oats Company and all of its subsidiaries. Included are all normally recurring adjustments necessary to present fairly the income for the reported periods. Interim results are unaudited, are not necessarily indicative of results for the full year, and are subject to adjustment during the remainder of the fiscal year.

The Quaker Oats Company and Subsidiaries
Condensed Statement of Consolidated Income (Unaudited)

Three Months Ended	Thousands of Dollars	
	September 30 1975	September 30 1974
Revenues:		
Net Sales	\$ 385,666	\$ 344,036
Other income (expense) — net	(1,075)	120
	<u>384,591</u>	<u>344,156</u>
Costs and Expenses:		
Cost of goods sold	263,742	261,219
Selling, general and administrative expenses	72,018	57,648
Interest expense	4,776	8,639
	<u>340,536</u>	<u>327,506</u>
Income Before Income Taxes	44,055	16,650
Provision for Income Taxes	<u>22,027</u>	<u>8,092</u>
Net Income	\$ 22,028	\$ 8,558
Net Income Per Common Share	\$1.00	\$.41
Average Number of Common Shares Outstanding	20,699,014	20,699,008

Condensed Consolidated Balance Sheet (Unaudited)**Assets**

	Thousands of Dollars	
September 30	1975	1974
Current Assets:		
Cash and marketable securities	\$ 4,981	\$ 26,181
Receivables — net	209,818	211,132
Inventories	201,108	228,423
Other current assets	<u>9,860</u>	<u>14,652</u>
Current assets	425,767	480,388
 Other Receivables and Investments	 7,219	 6,360
 Property, Plant and Equipment — net	 366,251	 328,679
 Intangible Assets	 <u>47,388</u>	 <u>44,594</u>
	 <u>\$846,625</u>	 <u>\$860,021</u>

The Quaker Oats Company and Subsidiaries

Liabilities

Thousands of Dollars

September 30	1975	1974
Current Liabilities:		
Short-term debt	\$ 65,349	\$168,589
Other current liabilities	158,724	129,367
Current liabilities	<u>224,073</u>	<u>297,956</u>
Long-Term Debt	147,887	174,190
Other Liabilities	9,489	7,185
Deferred Income Taxes	48,043	37,914
Shareholders' Equity:		
Preferred, \$50 par value, \$3 cumulative convertible, authorized 147,831 shares; issued 142,099 shares	7,105	7,105
Preference, without par value, \$100 stated value, \$9.56 cumulative, authorized 1,500,000 shares; issued 500,000 shares	50,000	—
Common, \$5 par value, authorized 35,000,000 shares; issued 20,948,934 and 20,948,922 shares, respectively	104,745	104,745
Additional paid-in capital	22,820	23,906
Reinvested earnings	<u>238,090</u>	<u>212,647</u>
	422,760	348,403
Less treasury common stock, at cost	5,627	5,627
Shareholders' equity	<u>417,133</u>	<u>342,776</u>
	<u>\$846,625</u>	<u>\$860,021</u>

The Quaker Oats Company and Subsidiaries
Condensed Consolidated Statement of Changes in
Financial Position (Unaudited)

Three Months Ended	Thousands of Dollars	
	September 30 1975	September 30 1974
Sources of Working Capital:		
Operations:		
Net Income	\$ 22,028	\$ 8,558
Depreciation, amortization, and deferred income taxes	9,966	8,627
Total from operations	<u>31,994</u>	<u>17,185</u>
Other — net	538	129
Total provided	<u>32,532</u>	<u>17,314</u>
Uses of Working Capital:		
Additions to properties	15,421	16,373
Cash dividends declared	5,648	4,246
Decreases (Increases) in long-term debt	10,396	(2,763)
Excess of cost over working capital of acquired businesses	5,621	87
Other — net	2,466	1,403
Total used	<u>39,552</u>	<u>19,346</u>
Decrease in Working Capital:	<u>\$ 7,020</u>	<u>\$ 2,032</u>
Consisting of:		
Cash and marketable securities	\$ (12,626)	\$ 14,499
Receivables — net	65,467	51,003
Inventories	12,405	3,251
Other current assets	2,850	5,357
Short-term debt	(36,821)	(53,894)
Other current liabilities	(38,295)	(22,248)
Net Decrease	<u>\$ (7,020)</u>	<u>\$ (2,032)</u>



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As a Quaker shareholder, I'd like more information about the Automatic Dividend Reinvestment Service, under which my dividend payments and any voluntary cash deposits I care to make can automatically be used to purchase additional shares of common stock for my account, without my having to pay any brokerage fees or service charges.

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\$ 7,020 **\$ 2,032**

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Net Decrease	<u>\$ (7,020)</u>	<u>\$ (2,032)</u>



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NEW

Ken-L
ration 

BURGE
AND
LIVER FLAVOR
CHUNKS

100% NUTRITIONALLY COMPLETE DIET

6 PACKS

NET WT.
(2 LB)


Aunt Jemima
Pancake Batter

JUST DEFROST AND POUR



DIRECTIONS
Defrost batter in refrigerator approximately 1 hour.
Puffest griddle 1/2 inch.
SHAKE BATTER ABOUT 1/2 inch.
Turn pancakes when edges turn cooked.
10-12 four-inch pancakes.
Allow defrostation.

The Quaker Oats Company

Merchandise Mart Plaza
Chicago, Illinois 60654

CELESTE PIZZA

No skimping

recipe.

